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E.O. 12958: N/A
TAGS: ECON EFIN CO
SUBJECT: COLOMBIA'S ECONOMY: STILL DEFYING GRAVITY

REF: A. BOGOTA: 11257

¶B. BOGOTA: 01383

¶1. (Summary) The Colombian economy demonstrated strong growth in 2005, despite the GOC's limited progress in addressing structural economic issues. GDP growth will be close to 5 percent and IMF targets for the budget, deficit, inflation and reserves were either met or exceeded. Public debt is less than 50 percent of GDP because of 5 billion USD worth of debt swaps and buy-backs, while exports grew more than 26.6 percent in 2005. Foreign direct investment grew 24 percent over 2004 and the stock market maintained its top 4 ranking, according to Bloomberg. Most importantly, unemployment continued to decline. But there are still significant areas for improvement. Two-thirds of the budget is still congressionally earmarked, severely limiting the GOC's spending flexibility; the GOC has not made sufficient progress in addressing structural fiscal reforms and the GOC continues to prove its susceptibility to special interest groups. The Free Trade Agreement will stimulate further improvement in these areas. (End Summary)

THE GOOD NEWS

¶2. Colombia's GDP growth for the year will surpass expectations and will likely be between 4.8 and 5.1 percent when it is announced in March or early April 2005. The GOC budget deficit at one percent of GDP was well under the IMF target of two percent of GDP. Inflation was the lowest in 50 years at 4.86 percent. The average foreign exchange rate appreciation of the peso between 2004 and 2005 was 11.9 percent, allowing the GOC to increase reserves beyond IMF targets, and restructure 5 billion USD worth of external debt with significant EURO and USD denominated buy-backs. The peso's appreciation also helped lower total foreign indebtedness to approximately 36 percent of GDP. Colombia now benefits from a debt structure that is more heavily comprised of domestic vs. externally issued debt. Notwithstanding the significant appreciation of the peso, exports grew 26.6 percent in 2005. Petroleum exports, which account for 53 percent of traditional exports, grew 31.5 percent. Coalexports, which account for 25 percent of traditional exports, grew 40.2 percent over 2004. Colombia currently boasts a 1.3 billion USD positive balance of trade. (NOTE: Total non-hydrocarbon exports grew by 22%)

¶3. Investor confidence, both foreign and domestic, continued to increase in 2005. S&P found that Colombia's ratio of investment to GDP has risen to more than 21 percent. Growing international reserves and declining external obligations led S&P to upgrade Colombia's long-term sovereign risk rating from stable to positive. The stock market continues to be among the top four for return on equity worldwide, as rated by Bloomberg. The index moved from 4,489 in January 2005 to

9,513.2 by the close of the year. Market capitalization was 50.7 billion USD by December 2005, an increase of 106 percent over last year. Domestic investment in plant and equipment, a good measure of future expanded productivity, grew 49.5 percent in 2005. At the same time Foreign Direct Investment (FDI) increased by 39 percent in the period of January to September 2005 over the same period in 2004. Colombians abroad repatriated 1 billion USD via portfolio investments, despite capital controls implemented in 2004 (REFTEL A) and an unofficial estimate places net foreign direct investment around 5.2 billion USD for 2005 (3.3 billion USD confirmed between January and September 2005).

¶4. 2005 was also a record year for mergers and acquisitions. Phillip Morris entered the Colombian market by purchasing COLTABACOS for 314 million uSD and South African brewer SAB-Miller purchased Colombia,s largest brewery, Bavaria, for 7.8 billion USD. The number of independent banks shrank because of mergers and foreclosures, going from 41 at the beginning of 2005 to 21 by the close of the year. Eleven banks of the 21 are currently filing chapter 11 and another 9 merged during the course of the year. Other purchases of note were BBVA,s purchase of GranAhorrar and the entrance of Falabella, a SODIMAC affiliate and Ripley,s of Chile, a Carrefour affiliate into the consumer credit market.

¶5. While the government has been realigning its debt structure, big businesses have been financing more of their growth via bond markets. Despite this trend, the loan portfolio of the entire banking sector grew 11.41 percent over the same period last year accompanied by a continued decrease in the value of past due debt (from 1.5 million dollars in Sept 2004 to 877,688 USD in Sept 2005).

¶6. Colombia's high structural deficit was offset in 2005 by increased tax receipts, mainly from growing exports. More than 19.3 billion USD were collected, with the greatest increases in corporate and personal income tax categories (14 percent more than targeted). Colombia,s tax base of one million individuals and companies is small, but it has more than doubled since 2002. The government plans to continue encouraging individuals to pay taxes and is more aggressively targeting tax evaders. The GOC's target for tax collections in 2006 is a reasonable 48 trillion COP (21.3 billion USD).

OPPORTUNITIES FOR IMPROVEMENT

¶7. The GOC hopes to continue its reforms and is focusing on rationalizing spending and tax reform. 2004 tax reforms improved collections by both increasing collections and

expanding the tax base. Nevertheless, with the region's highest nominal tax rates, as high as 38.5 percent for income tax and 16 percent for VAT taxes, and with the marginal tax rate approaching 50 percent in the manufacturing sector, further reforms are needed. The GOC also needs to increase its discretion. The government,s tax revenue (about 20 percent of GDP) cover four earmarked expenses: constitutionally mandated transfers to the regions, at 6 percent of GDP (REFTEL B); another 4 percent for security related expenses; 5 percent for social security and pensions; and another 5 percent for debt servicing.

WHAT MAY COME: 2006

¶8. Economists and experts in Colombia predict that the economy will grow around 4 percent in 2006. The projected slowdown is attributable Colombia's susceptibility to an estimated worldwide slowdown. Inflation is expected to remain low at 4.86 percent while interest rates are expected to move up slightly to 7.38 percent. Most economists agree that the peso will begin to devalue, perhaps as much as 3 percent compared to the US dollar. Experts worry that Colombia's ability to cheaply finance its fiscal deficit will weaken because U.S. and European interest rates are climbing. The Finance Ministry indicated that it plans to take

preemptive action by issuing new government paper, close to 1 billion USD in 2006, to finance what may not be so readily available later. With conclusion of negotiations on a Free Trade Agreement with the U.S., we expect ratification, adoption of implementing legislation, and reforms to increase market competitiveness to play a big role in 2006.
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